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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

To: The Commission

REPLY COMMENTS OF COUNSEL
TO THE MUNICIPAL FRANCHISING AUTHORITIES

Duncan, Weinberg, Miller & Pembroke, P.C. and Snavely, King & Associates, Inc. (hereafter counsel for "Municipal Franchising Authorities" or "MFA") herewith submit reply comments in the above-captioned proceeding. The MFA filed Comments in this proceeding, and they herewith reply to the Comments of various other parties to this proceeding.

1. The MFA reiterate that the Commission: (a) should establish rules that cannot be manipulated or "gamed" by cable operators; (b) should apply lessons learned in telephone industry regulation to the cable industry, and (c) should disallow all monopoly-based excess acquisition costs from the rate base.

The Commission Should Establish Rules That
Cannot Be Manipulated or "Gamed" By Cable Operators

2. In its earlier Comments, the MFA advocated drafting regulations for cable television that would not be subject to gaming by the cable companies. Many consumer and regulatory groups echoed this concern.

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3. The cable companies universally seek rules that allow them to (1) maintain their current excessive rates, (2) add increments of price above any benchmark that may be set and (3) keep in the ratebase the present value of supernormal returns they anticipated earning from monopoly services.[1/] These three goals, if realized, will produce higher rates and monopoly service for the consumer, and supernormal profits [2/] for the cable companies.

The Harmful Potential of Ad Hoc Add-Ons to Benchmarks

4. Many cable companies want the FCC to create a mixed or hybrid regulatory system. The operators seek to keep benchmark prices and concurrently allow partial participation in cost-of-service proceedings on an *ad hoc* basis, whenever a single cost element in a cable system is above average costs ("Ad Hoc Add-Ons").[3/] Ad Hoc Add-Ons would result in higher rates for the consumer and supernormal profits for the operators.

1/ The present value of supernormal returns anticipated from monopoly service is defined as the "franchise value" in a report by William B. Shew of National Economic Research Associates, Inc. (NERA). This report, dated November 30, 1989, ("NERA Report") was submitted by Tele-Communications Inc. (TCI) in Docket No. 268-89 of the United States Tax Court. It stated "The value of a franchise stems from the prospect it offers to earn supernormal profits. For this prospect to be credible, the franchise holder must expect that he will be insulated from intensive competition. Otherwise, the allure of supernormal returns would attract firms into the market until the rate of return was driven down to the normal level." NERA Report at page 4.

2/ "Supernormal profits" for the cable industry are returns substantially above the Rate of Return allowed to an appropriate surrogate industry -- the Local Exchange Companies (LECs).

3/ The Ad Hoc Add-On system is fully described in Comments of Tele-Communications, Inc., pages 16 - 22.

5. An Ad Hoc Add-On system would create discrete cost categories within a company or system and allow cable companies to initiate limited cost-of-service proceedings to demonstrate that one or more cost categories had costs exceeding expectations. The "excess" cost would be added to the benchmark rates, raising the total cost to consumers. However, the limited cost-of-service proceeding would not permit examination of the total costs of the system as a whole. Thus, if a company had only one cost category above normal and all other cost categories were far below normal, then it would reap supernormal profits in an Ad Hoc Add-On system.

6. The MFA have urged the FCC to reconsider its proposal to adopt a generic cost-of-service approach, and, instead, to apply exclusively the benchmark/price cap approach. Nevertheless, if cost-of-service proceedings are to be employed to determine the reasonableness of rates, then they must require complete cost-of-service studies and not allow "cherry picking" of the most advantageous cost items.

The Commission Should Apply Lessons Learned in the Telephone Industry to the Newly-Regulated Cable Industry

7. In many of their comments, the cable companies disparage the ability of the Commission and its staff to regulate effectively. Time Warner, for example, wrote that "Given its current level of knowledge of the cable industry and its total lack of experience with cable price regulation, the Commission is in no position to define and prescribe forms for cost-based price

presentations."[4] The cable companies predict dire consequences from the Commission's regulation of the cable industry. One wrote that "Blind adherence to traditional rate of return principles will jeopardize the future development of cable television's role in a competitive telecommunications infrastructure."[5]

8. This belief and the predictions that flow from it are unwarranted. Congress delegated the authority to the Commission, and the FCC is entitled to apply its sixty years of regulatory experience to the tasks of cable regulation. The Commission demonstrated in the NPRM the breadth of its knowledge of the regulatory issues and alternatives. Specifically, the MFA hope that the Commission will apply lessons learned in telephone service regulation to issues in the cable industry. Telecommunications innovation has flourished under the Commission's guidance, and the price of service has declined. This should be the goal of cable regulation.

Rate Of Return Surrogate

9. The MFA are unconvinced by cable company arguments in this proceeding that those companies are competitive, entrepreneurial and comparable to the Fortune 400 in their risk characteristics, given that the cable industry has argued in federal court that they must be "insulated from intensive competition" to have any value to their franchises.[6]

4/ Comments of Time Warner Entertainment Company, at page 20.

5/ Comments of the Medium-Sized Operators Group, page 28.

6/ NERA Report, page 4.

10. From a consumer perspective the Fortune 400 surrogate seems ludicrous. The Fortune 400 are unambiguously different from cable television operators.

11. Instead, cable television systems strongly resemble local exchange telephone service providers. In fact, many predict that these two separate industries soon will be in direct competition with one another. The use of the Local Exchange Companies as surrogates now will be appropriate because it will provide a comparable basis for analysis and will ease "level playing field" issues arising when the two industries begin head-to-head competition.

<u>Consistent Actual Service-Life-Based Depreciation</u>

12. In their comments the cable companies attempt to avoid the appropriate standardization of their depreciation practices.[7/] The Commission should apply its experience in depreciation and define uniform accounts and procedures to derive service-life-based depreciation schedules.

13. Even Arthur Andersen, which elsewhere testifies on behalf of the cable companies, notes that "A simplified, uniform system of accounts (USOA), prescribed depreciation lives, a generic rate of return, standard cost allocation procedures and a common filing and reporting format will greatly aid all parties."[8/] Haphazard, nonstandard depreciation techniques will be

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7/ Comments of the Medium-Sized Operators Group, page 22: "Cable company depreciation rates should be presumed reasonable."

8/ Comments of Arthur Andersen & Co., at page 4.

harmful to all parties, except the cable companies, who may use their choice of depreciation techniques to mask supernormal returns and raise cable rates.

The Commission Should Disallow All Monopoly-Based Excess Acquisition Costs

14. The cable companies used much commenting space to spin theories on why they should keep their excess acquisition costs in the ratebase as intangible assets. They write that the acquisition costs include sunk start-up costs[9/] and the value of efficiency differences between buyer and seller.[10/]

15. The Commission was right in preliminarily concluding that it was inappropriate to include excess acquisition costs. The ratebase should contain only used and useful investments that provide cable service to current subscribers. That ratebase should be valued at original cost minus accumulated service-life-based depreciation.

16. There is no need to discuss valuation and pricing of going concerns, since the correct financial theory is long-established. Nevertheless, since the cable companies have raised the matter, the following analogy shows the flaws in their reasoning, without losing the theoretical underpinnings of the analysis.

9/ Comments of the Medium-Sized Operators Group, page 21; Comments of Tele-Communications, Inc., page 21.

10/ Comments of Prime Cable, et al. and the Coalition of Small System Operators, page 32; Comments of Tele-Communications, Inc., page 18.

17. If one were considering the purchase of a pizza store and trying to determine the fair price for the store, the only consideration would be the expected return from the store. If one believed the store would have revenues of $10.00 a day and expenses of $9.00 a day, then the maximum value of the store would be the present value of $1.00 a day in perpetuity -- this is the expected return from the store. It doesn't matter whether the owner painted the store last week.[11/]

18. The efficiency of the seller also is not paramount, except in relation to the buyer's efficiency: if the buyer is <u>more</u> efficient, the value of the store to the seller is <u>less</u> than the value of the store will be to the more efficient buyer considering the purchase. Therefore, the buyer attempts to negotiate the price <u>down</u> to the seller's efficiency-based value. Despite the arguments to the contrary by the cable operators in their comments, the buyer does not foolishly add any benefits of its own efficiency to the seller's profit. In purchasing a going concern the <u>rational</u> investor will <u>never</u> pay more than the expected return on an investment.

19. If the pizza store were like a cable company and had the exclusive franchise to sell pizzas to a college, then the purchaser could anticipate supernormal returns if the purchaser were willing to charge high prices for the pizza. If no one at the college had ever heard of pizza before, then the pizza store

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<u>11</u>/ This may add to expenses, but the value of the on-going concern is still the present value of the expected return, not the expected return plus cost of paint expended.

might lower prices on pizza until a customer base were built and then charge high prices to gain a supernormal return.[12/] The low prices act as marketing expense to gain customers. If, during this period of low prices, the pizza store was sold it would still command a high price, but only because of anticipated supernormal returns, not because the current owner had accrued salable losses.

20. If one day the college administration finds out the students are being overcharged for pizza, then the administration might regulate the price of pizza to a benchmark level. The value of the pizza store will then drop as the anticipated supernormal returns are removed from consideration.

21. This simple theory of value was once professed by the cable industry. In 1989 the cable industry was unregulated and was not trying to explain away their supernormal returns. In the 1989 NERA Report they were trying to quantify their future returns for tax purposes, adhering to the accepted theories of investment.

22. The NERA Report examined three different methods of valuing franchises: current market value, reproduction cost and expected income. It found that current market value of

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12/ Cf. Comments of Tele-Communications, Inc., page 24: "In the early years of a system's operation, the full cost of providing cable service is not charged to subscribers, since that would discourage subscribers from taking service." Cf. Comments of the Medium-Sized Operators Group, page 9: "The expectation was that the rates could be increased in future years to offset the initial losses, as customers received added value and became accustomed to the increased rates."

comparable assets was inadequate because it "would encounter serious difficulty in establishing which, if any, traded franchises are comparable to the franchise being evaluated."[13/] It found that reproduction cost was inadequate because it "does not provide a suitable basis for estimating the value of a cable franchise."[14/] It found that the best way to evaluate the price of a franchise was to determine present value of expected returns, writing that "The natural means of determining franchise value is the income approach, because the value of a cable franchise is the (capitalized) income over and above what would provide the investor with a competitive rate of return for the risk involved."[15/] This income above a competitive rate of return for the risk involved is the cable operators' pre-regulatory supernormal return reflected in excess acquisition costs.

23. A goal of regulation is to assure that ratepayers are not burdened with the supernormal return expectations of cable operators. Including any of the excess acquisition costs of cable companies in the ratebase would lay the burden of operators' unsuccessful speculation onto the ratepayers/cable subscribers. The Commission should ignore spurious arguments and establish original cost of used and useful investments minus accumulated service-life-based depreciation as the derivation formula for establishing the ratebase of the cable industry.

13/ NERA Report, page 17.

14/ NERA Report, page 16.

15/ NERA Report, page 18.

24. In closing, when establishing cost-of-service criteria, the Commission: (a) should establish rules that cannot be manipulated or "gamed" by cable operators; (b) should apply lessons learned in telephone industry regulation to the cable industry, and (c) should disallow all monopoly-based excess acquisition costs from the rate base. These points are reasonable and consistent with Congressional intent, inasmuch as cable operators will have the exclusive and unilateral right to elect to initiate cost-of-service proceedings to justify higher rates.

Dated: September 14, 1993

Respectfully submitted,

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